(1) 96 592 OCT 15 1996

OFFICE OF THE CLERK

No. 96- ———

IN THE

Supreme Court of the United States

OCTOBER TERM, 1996

———

SPEAR, LEEDS & KELLOGG,
Petitioner,

v.

CENTRAL LIFE ASSURANCE COMPANY, ALEXANDER HAMILTON LIFE INSURANCE COMPANY OF AMERICA, INC., and CANADA LIFE ASSURANCE CO.,
Respondents.

———

Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

———

PETITION FOR A WRIT OF CERTIORARI

———

HOWARD SCHIFFMAN
(Counsel of Record)
WOODY N. PETERSON
DICKSTEIN SHAPIRO MORIN
& OSHINSKY LLP
2101 L Street, N.W.
Washington, D.C. 20037-1526
(202) 785-9700
Attorneys for Petitioner
Spear, Leeds & Kellogg

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

59 pp

QUESTION PRESENTED

Whether, under provisions of the New York Stock Exchange ("NYSE") Constitution and Rules mandated by the Securities Exchange Act of 1934, NYSE members are compelled to arbitrate claims of nonmembers with whom the members have no business relationship.

RULE 29.6 STATEMENT

Pursuant to this Court's Rule 29.6, Petitioner Spear, Leeds & Kellogg states that it is not a corporation, and has no parent company or nonwholly owned subsidiaries.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
RULE 29.6 STATEMENT	ii
TABLE OF AUTHORITIES	iv
OPINIONS BELOW	1
JURISDICTION	1
STATUTES AND REGULATIONS INVOLVED	2
STATEMENT	4
REASONS FOR GRANTING THE PETITION	7
THE QUESTION PRESENTED RAISES IMPORTANT ISSUES AS TO THE SCOPE OF EXCHANGE SELF-REGULATION	7
CONCLUSION	13

TABLE OF AUTHORITIES

Cases: Page

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) 8

Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 114 S. Ct. 1439 (1994) 8

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) .. 8, 10, 11

First Options of Chicago, Inc. v. Kaplan, 115 S.Ct. 1920 (1995) 10

Haviland v. Goldman, Sachs & Co., 947 F.2d 601 (2d Cir. 1991), *cert. denied*, 504 U.S. 930 (1992), *affirming* 736 F. Supp. 507 (S.D.N.Y. 1990) 12

Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117 (1973) 9

Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985) 10

National Railroad Passenger Corp. v. Boston and Maine Corp., 850 F.2d 756 (D.C. Cir. 1988) 10

Pearce v. E.F. Hutton Group, Inc., 828 F.2d 826 (D.C. Cir. 1987) 9

Silver v. New York Stock Exchange, 373 U.S. 341 (1963) 7, 8

Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931) 8, 11

Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ., 489 U.S. 468 (1989) 10

Wheat, First Securities, Inc. v. Green, 993 F.2d 814 (11th Cir. 1993) 12, 13

Statutes:

9 U.S.C. § 2 4

15 U.S.C. § 78a, *et seq.* 7

15 U.S.C. § 78f(b)(5) 2

15 U.S.C. § 78f(b)(6) 2

28 U.S.C. § 1254(1) 1

28 U.S.C. § 1332 1

New York Stock Exchange Constitution and Rules:

Constitution Article XI, Section 1 ..... 3, 6

Rule 342(b) 2, 5, 9

TABLE OF AUTHORITIES—Continued

Page

Rule 401 ..... 2, 3, 5, 9
Rule 600(a) 4, 6

Legislative Material:

SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 1 and pt. 4 (1963) 9

Miscellaneous:

Joseph Kenrick, *New York Stock Exchange Fact Book*, December 1995 NYSE Monthly Volume Release 7
"Pennies From Heaven," *Philadelphia Magazine* (August 1993) 6

IN THE

Supreme Court of the United States

OCTOBER TERM, 1996

No. 96-———

SPEAR, LEEDS & KELLOGG,

Petitioner,

v.

CENTRAL LIFE ASSURANCE COMPANY, ALEXANDER HAMILTON LIFE INSURANCE COMPANY OF AMERICA, INC., and CANADA LIFE ASSURANCE CO.,

Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

---

PETITION FOR A WRIT OF CERTIORARI

OPINIONS BELOW

The opinion of the court of appeals (A. 1a-28a) is reported at 85 F.3d 21 (2d Cir. 1996). The district court opinion which the court of appeals panel majority reversed (A. 29a-35a) is reported at 879 F. Supp. 403 (S.D.N.Y. 1995).

JURISDICTION

The district court had jurisdiction over this case pursuant to 28 U.S.C. § 1332. The judgment of the court of appeals was entered on May 16, 1996 (A. 38a-39a). Petitioner's timely petition for rehearing was denied on July 17, 1996 (A. 36a-37a). This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

Sections 6(b)(5) and 6(b)(6) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. §§ 78f(b)(5) and 78f(b)(6), provide:

> (b) An exchange shall not be registered as a national securities exchange unless the Commission determines that—
>
> * * * *
>
> (5) The rules of the exchange are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this chapter matters not related to the purposes of this chapter or the administration of the exchange.
>
> (6) The rules of the exchange provide that (subject to any rule or order of the Commission pursuant to section 78q(d) or 78s(g)(2) of this title) its members and persons associated with its members shall be appropriately disciplined for violation of the provisions of this chapter, the rules or regulations thereunder, or the rules of the exchange, by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.

Rules 342(b) and 401 of the New York Stock Exchange state:

> *Offices—Approval, Supervision and Control*
>
> Rule 342. (b) The general partners or directors of each member organization shall provide for appro-

priate supervisory control and shall designate a general partner or principal executive officer to assume overall authority and responsibility for internal supervision and control of the organization and compliance with securities' laws and regulations. This person shall:

(1) delegate to qualified principals or employees responsibility and authority for supervision and control of each office, department or business activity, and provide for appropriate procedures of supervision and control.

(2) establish a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised.

Business Conduct

Rule 401. Every member, allied member and member organization shall at all times adhere to the principles of good business practice in the conduct of his or its business affairs.

The relevant provisions of the NYSE Constitution and Rules governing arbitration provide:

ARTICLE XI

Arbitration

Controversies Arbitrated

Sec. 1. *Controversies Arbitrated.* Any controversy between parties who are members, allied members or member organizations and any controversy between a member, allied member or member organization and any other person arising out of the business of such member, allied member or member organization, or the dissolution of a member organization, shall at the instance of any such party be submitted for arbitration in accordance with the provisions of this Constitution and such rules as the Board may from time to time adopt.

Arbitration

> Rule 600. (a) Any dispute, claim or controversy between a customer or non-member and a member, allied member, member organization and/or associated person arising in connection with the business of such member, allied member, member organization and/or associated person in connection with his activities as an associated person shall be arbitrated under the Constitution and Rules of the New York Stock Exchange, Inc. as provided by any duly executed and enforceable written agreement or upon the demand of the customer or non-member.

The Federal Arbitration Act, 9 U.S.C. § 2, provides in relevant part that arbitration agreements

> shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

STATEMENT

In November 1990, Marvin J. Goodman, a professional commodities trader, transferred his commodities futures account to petitioner Spear, Leeds & Kellogg ("Spear, Leeds").[1] Eleven months later, Goodman, who had purchased policies on his life from the respondent insurers, suffered a fatal heart attack.

When Goodman died, he was under investigation by the CFTC. Spear, Leeds discovered for the first time in the course of that investigation that, contrary to his repeated representations, Goodman had client investors in subac-

---

[1] Spear, Leeds is a futures commission merchant registered with, and regulated by, the Commodity Futures Trading Commission ("CFTC"), and a member of numerous futures and stock exchanges, including the New York Stock Exchange ("NYSE"). The precious metals trades Spear, Leeds cleared for Goodman involved commodities futures, not stocks listed on the NYSE.

counts of his Spear, Leeds account,[2] and had put these investors' money in a commodities pool.[3] Still later, Spear, Leeds learned for the first time that Goodman had purchased life insurance from respondents and other insurance companies, payable to trustees for his undisclosed clients in the event of his death.[4]

In connection with Goodman's life insurance applications, respondents apparently sought and received from Goodman the usual medical and other information life insurers typically rely on to assess their risks. Goodman also provided respondents with portions of his Spear, Leeds commodities account statement that he carefully selected to create the impression of substantial credit balances; Goodman deliberately omitted the remaining parts of his commodities account statement which reduced his net account equity.

Respondents never asked Spear, Leeds to, and Spear, Leeds never did, provide the life insurers with any infor-

---

[2] At Goodman's request, Spear, Leeds had established his commodities account in the same way as his previous clearing broker had, namely as one account, with subaccounts (all bearing Goodman's name and social security number) set up by Goodman under the single account number. Some of Goodman's subaccounts had credit balances, while others had debit balances. Spear, Leeds regularly provided Goodman with unified statements for his one commodities account, including all of his subaccounts, which accurately reflected its overall value.

[3] Goodman's conduct put Spear, Leeds in a position that ultimately led it to consent to settlements (without any admission of liability) of a CFTC regulatory proceeding consisting of a penalty of $325,000, and of an NYSE and New York Futures Exchange proceeding, consisting of a censure and fines totaling $75,000, for alleged violations of NYSE Rules 342(b) and 401.

[4] The trustees of the insurance trusts created by Goodman were to pay the proceeds first to the persons who had given Goodman money for him to trade (since the account was in Goodman's name, these individuals would otherwise not be paid until Goodman's estate was probated), and to hold the remainder in continuing trust for Goodman's heirs.

mation about Goodman or his commodities account. Indeed, Spear, Leeds never communicated with respondents about anything, and had no knowledge of Goodman's dealings with them, or of his life insurance, until after he died.[5]

Upon Goodman's death, his trusts collected the life insurance benefits from respondents and distributed them to his clients and his heirs. Thereafter, the insurers filed an arbitration claim under NYSE Constitution Article XI, Section 1, and related NYSE Rule 600(a), seeking to hold Spear, Leeds responsible for their own decision to insure Goodman's life.[6]

Spear, Leeds then successfully moved the District Court for the Southern District of New York for a preliminary injunction enjoining respondents from forcing Spear, Leeds to arbitrate respondents' claim before the New York Stock Exchange. The district court found the arbitration provisions inapplicable, because the claim did not arise in connection with Spear, Leeds' business as an NYSE member:

---

[5] For a full recitation of Goodman's colorful saga, *see* the article "Pennies From Heaven," *Philadelphia Magazine* (August 1993), at 88-91, 178-83.

[6] Article XI, Section 1 states in pertinent part that:

> Any controversy . . . between a member . . . and any other person *arising out of the business of such member* . . . shall at the instance of any such party be submitted for arbitration in accordance with the provisions of this Constitution and such rules as the Board may from time to time adopt. [Emphasis added.]

Rule 600(a) provides in relevant part that:

> Any dispute, claim or controversy between a . . . non-member and a member . . . *arising in connection with the business of such member* . . . shall be arbitrated under the Constitution and Rules of the [NYSE] as provided by any duly executed and enforceable written agreement or upon the demand of the . . . non-member. [Emphasis added.]

> I cannot find any relationship between the NYSE member and the nonmember, except that the nonmember was the insurance carrier of a customer of the member. There is no authority establishing the point at which a sufficient nexus is reached between the parties to warrant NYSE arbitration, but wherever that point may be, this situation is far from it. [(A. 35a.)]

The court of appeals majority, over a powerful dissent, reversed, holding that requiring Spear, Leeds to arbitrate such a claim under the NYSE Constitution and Rules would serve the purposes of the Securities Exchange Act of 1934, by "allowing and facilitating vigorous self-regulation." (A. 18a.)

REASONS FOR GRANTING THE PETITION

THE QUESTION PRESENTED RAISES IMPORTANT ISSUES AS TO THE SCOPE OF EXCHANGE SELF-REGULATION

This case, like *Silver v. New York Stock Exchange*, 373 U.S. 341, 342-43 (1963), involves a question "of great importance to the public and the financial community," as to the limits of the obligations of exchange members towards nonmembers under constitutional provisions and rules mandated by the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78a, *et seq.* (the "Exchange Act").[7] The court of appeals majority has expanded the NYSE's role as arbiter far beyond that given it by the Exchange Act—the policing of members' relationships

[7] This Court noted in *Silver* that in view of the NYSE's $47.4 billion trading volume in 1962, the importance of the role of exchanges in this country "in dollar terms is vast." 373 U.S. at 349-50. The NYSE remains "by far the largest" of the exchanges regulated by the Securities and Exchange Commission (*id.* at 350) and its economic impact has grown exponentially, with $3.1 trillion in stock transactions in 1995. *See* Joseph Kenrick, *New York Stock Exchange Fact Book*, December 1995 NYSE Monthly Volume Release.

with investors, customers or employees, or others with whom exchange members have a business relationship. In Justice Cardozo's classic language, the court of appeals' decision exposes exchange members to arbitration of claims of a "liability in an indeterminate amount for an indeterminate time to an indeterminate class." *Ultramares Corp. v. Touche*, 255 N.Y. 170, 179, 174 N.E. 441, 444 (1931). This is inconsistent with the policies and goals of the Exchange Act and the NYSE Rules mandated by the Act, as well as this Court's precedents.[8]

The Exchange Act creates a "federally mandated duty of self-policing by exchanges," which requires them to promulgate rules governing their members' conduct that ensure fair dealing and the protection of investors. *Silver*, 373 U.S. at 352-53. Those rules include the regulation of "members' relationships with nonmembers," in light of the potential injury "to the investing public and Exchange members" that can result from a member's "transactions" and "dealings with" nonmembers. *Id.* at 354 & n.9, 355. The question presented here is whether these statutory goals justify compelling a member to arbitrate claims by nonmembers, where there is no business relationship between the member and the nonmembers.

---

[8] *Cf. Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 747-48 (1975) (declining to expand class of plaintiffs who may maintain private right of action for violations of SEC Rule 10b-5 beyond actual purchasers and sellers of securities, and noting that, in view of *Ultramares*, "we are not the first court to express concern that the inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good"); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 & n.33 (1976) (also relying on *Ultramares* in refusing to broaden class of plaintiffs who could sue under § 10(b) of the Exchange Act to include those who alleged negligence by accountants); *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439, 1454 (1994) (imposing "[s]econdary liability for aiders and abettors [under Rule 10b-5] exacts costs that may disserve the goals of fair dealing and efficiency in the securities markets," including uncertainty, vexatious litigation and undesirable ripple effects on industry professionals and investors).

As this Court noted in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117, 135-36 (1973), compelling arbitration of claims by non-investors arising from rules violations "is no substitute for direct effective disciplinary action against any abusive exchange practice." In such circumstances, any connection with the statutory goals of fair dealing and investor protection is " 'extremely attenuated and peripheral, if it exists at all.' " *Id.* at 134-35 (citation omitted). There was thus no basis for the court of appeals majority's view that the Exchange Act and NYSE disciplinary rules give a member a "reasonable expectation" of having to arbitrate claims by nonmember strangers, pursuant to the NYSE's statutory "self-regulation" mandate.[9]

---

[9] The panel majority below relied on the fact that there had been an NYSE disciplinary proceeding relating to Spear, Leeds' handling of Goodman's account. But the NYSE proceeding did not involve Goodman's life insurance applications, or Goodman's wrongful conduct in *his* dealings with the insurers.

The NYSE disciplinary proceeding instead centered on Spear, Leeds' inadequate internal supervision of the opening of Goodman's *subaccounts* under NYSE Rules 342(b) and 401. Those NYSE Rules are designed only to protect NYSE *members*, by ensuring that they follow good business practices in managing their firms, and the *customers* of those members, by ensuring that the customers' accounts are properly supervised and handled. *See* SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 1, at 5, 9, 11 (Rules designed to protect member firms and investors), and pt. 4, at 574, 575, 719 (NYSE nonmember arbitration provisions are for the benefit of investors and customers of members) (1963). These concerns, policy goals and classes protected have nothing to do with respondent life insurance companies or their far-fetched claim, which Judge Pollack aptly termed an "unsupportable . . . concoction." (A. 28a n.2.)

Simply put, the insurers' claim rests on the mere "fortuity" of Spear, Leeds' "membership in the NYSE," as the insurers' claim "raises no issues" regarding Goodman's conduct "that would not also arise" if Goodman had submitted a misleading medical history, a doctored tax return or other false information to respondents in applying for his life insurance. *Pearce v. E.F. Hutton Group, Inc.*, 828 F.2d 826, 832 (D.C. Cir. 1987). The insurers' failure to contact

The ruling of the court of appeals majority likewise goes far beyond the "intent of the parties" limit on arbitrability set by this Court's jurisprudence under the Federal Arbitration Act ("FAA"). *See Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 626 (1985) ("as with any other contract, the parties' intentions control" the construction of arbitration agreements under the FAA). The FAA is designed " 'to make arbitration agreements as enforceable as other contracts, *but not more so.*' " *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 478 (1989) (emphasis added) (citation omitted).[10] This principle "flow[s] inexorably" from the fact that exchange arbitration is simply "a way to resolve those disputes—*but only those disputes*—that the parties have agreed to submit to arbitration." *First Options of Chicago, Inc. v. Kaplan*, 115 S. Ct. 1920, 1924 (1995) (emphasis added).[11]

Spear, Leeds to confirm Goodman's account status underscores just how "fortuitous" Spear, Leeds' membership was to their decision to insure Goodman's life. The insurers did contact, and obtained detailed information from, Goodman's physicians, as his medical condition and life expectancy were hardly "fortuitous" when it came to insuring his *life*.

[10] For that reason, the federal policy favoring arbitration alone cannot be enough to extend the application of an arbitration clause far beyond its intended scope. As the District of Columbia Circuit has observed, if the courts

> allow the federal policy favoring arbitration, with its accompanying presumption of arbitrability, to override the will of the parties by giving the arbitration clause greater coverage than the parties intended, then in the longer run we risk undermining rather than serving that policy.

National Railroad Passenger Corp. v. Boston and Maine Corp., 850 F.2d 756, 760 (D.C. Cir. 1988).

[11] Like *Hochfelder*, "[t]his case, on its facts, illustrates the extreme reach of the standard urged by respondents" and adopted by the court below, if only because "[a]cceptance of respondents' view would extend to new frontiers the 'hazards' " of doing busi-

As dissenting Judge Pollack emphasized, "[n]o matter how the semantics are arranged, the instant claims to recover life insurance payments made to Goodman's customers at his death" cannot be considered "claims arising in connection with the business" of Goodman's commodities account clearing broker. (A. 27a n.2.) In the final analysis, Judge Pollack wrote,

> [t]he notion of "arising out of exchange-related business" must be limited in some manner, lest *any* third party could compel an exchange member to arbitrate any claim, so long as some tenuous link to the member's "business" be alleged. [(A. 28a n.2) (emphasis in opinion).]

That limitation

> should take the form of *either a direct contract between the parties, or a relationship between the parties, such that they stand in the "chain of commerce," one with the other* . . . . The claims at issue here simply fail such a test. [(A. 28a n.2) (emphasis added).]

The panel majority's contrary view has no principled limits. Under their rationale, a member, upon joining the NYSE, is deemed to have contractually agreed to arbitrate with *strangers*, and with anyone who had *any* relationship in any capacity with any person who fortuitiously happened to be a customer of the member.

If not corrected, this boundless reading of the NYSE Constitution and Rules would require arbitration at the behest of a landlord whose tenant defaulted on a lease, if the landlord claimed that the tenant lost money by reason of a broker's violation of an NYSE Rule. Even that scenario assumes some breach by the NYSE member of a duty to a customer with respect to NYSE-traded stocks. The decision below goes further by requiring arbitration

---

ness in the securities industry. 425 U.S. at 215-16 n.33 (quoting *Ultramares*).

of claims wholly unrelated to any such breach, and involving only the unilateral and covert conduct of a customer towards a third party unknown to the member.[12]

Here, the only potential victims of any wrongdoing with respect to Goodman's account were his investors, all of whom were made whole by the proceeds of the life insurance Goodman allegedly procured by fraud without Spear, Leeds' knowledge or involvement. The lack of any nexus between Goodman's life insurance fraud and Spear, Leeds is further illustrated by the fact that if Goodman had made every penny in commodities trading that he told the insurers he did, the insurance companies would *still* have had to pay the policy proceeds to Goodman's trusts upon his death.[13]

Until the panel majority decision here, *no* court anywhere had ever extended the reach of arbitration under the Exchange Act or the FAA to such an extent. Dissenting Judge Pollack correctly characterized the only other court of appeals case to deal with this issue as follows:

> As the Eleventh Circuit recently held in an analogous NASD context, the fact that the non-member and member "had absolutely no relationship" to each other "at the time of the alleged events that the [non-member] seek[s] to arbitrate", affords a "compelling basis" for the conclusion that the member could not be deemed to have agreed to arbitrate with a non-member stranger. *Wheat, First Securities, Inc. v.*

---

[12] Moreover, all of the account and clearing work Spear, Leeds did on Goodman's behalf related solely to commodities not traded on the NYSE. *See Haviland v. Goldman, Sachs & Co.*, 947 F.2d 601, 609-10 (2d Cir. 1991), *cert. denied*, 504 U.S. 930 (1992), *affirming* 736 F. Supp. 507, 510 (S.D.N.Y. 1990) (relying on this fact to find dispute not arbitrable).

[13] In fact, they would have paid *more* ($3 million face value) if Goodman had been as successful as he represented to the insurers. The insurers ended up paying only $1.92 million thanks to a settlement made possible by the fortuity (from a *life* insurance perspective) that Goodman had been losing money trading when he died.

Green, 993 F.2d 814, 818 (11th Cir. 1993). [(A. 24a.)]

The Eleventh Circuit held in *Wheat, First* that to require members to arbitrate claims of nonmembers with whom members have no business relationship "would do significant injustice to the [members'] reasonable expectations." 933 F.2d at 820. In so holding, the Eleventh Circuit stressed the "potential for abuse" inherent in compelling arbitration of such claims. *Id.* This Court has been vigilant in setting precise limits on the scope of exchange self-regulation under the Exchange Act and on the reach of arbitration under the FAA. It should grant this Petition to protect exchange members from the "abuse" of those limits that will otherwise result if the court of appeals majority decision stands uncorrected.

CONCLUSION

For the foregoing reasons, the Petition should be granted.

Respectfully submitted,

HOWARD SCHIFFMAN
(Counsel of Record)
WOODY N. PETERSON
DICKSTEIN SHAPIRO MORIN
& OSHINSKY LLP
2101 L Street, N.W.
Washington, D.C. 20037-1526
(202) 785-9700
Attorneys for Petitioner
Spear, Leeds & Kellogg

October, 1996

APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 331—August Term 1995

(Argued October 16, 1995 Decided May 16, 1996)

Docket No. 95-7372

SPEAR, LEEDS & KELLOGG,
Plaintiff-Appellee,

—v.—

CENTRAL LIFE ASSURANCE COMPANY, ALEXANDER HAMILTON LIFE INSURANCE COMPANY OF AMERICA, INC., CANADA LIFE ASSURANCE CO.,
Defendants-Appellants.

Before:

CARDAMONE and MAHONEY, *Circuit Judges,*
and POLLACK,* *District Judge.*

CARDAMONE, *Circuit Judge*:

On this appeal from the grant of a preliminary injunction enjoining arbitration, issued by the United States District Court for the Southern District of New York (Duffy, J.), we are asked to decide whether plaintiff

* Hon. Milton Pollack, United States District Judge for the Southern District of New York, sitting by designation.

Spear, Leeds & Kellogg (plaintiff, broker, or Spear, Leeds), a member of the New York Stock Exchange (NYSE or Exchange), is required under the Exchange's Constitution and Arbitration Rules to arbitrate a dispute with the defendants-appellants Central Life Assurance Company, Alexander Hamilton Life Insurance Company of America, Inc., and Canada Life Assurance Company (defendants, appellants, or insurance companies). None of the defendants are Exchange members. The district court granted the injunction barring arbitration because it found there was no contract between the parties to arbitrate.

In so ruling the district judge relied on our decision denying arbitration in *Paine, Webber, Jackson & Curtis, Inc. v. Chase Manhattan Bank, N.A.*, 728 F.2d 577 (2d Cir. 1984). There, the dispute—unrelated to exchange business—was between defendants that were not NYSE members and a plaintiff that was a member. We held that because the alleged improper conduct was by the non-member, arbitration should be limited to those disputes that come about as a result of the member's exchange-related business. *Id.* at 580. The dispute before us today arises between a member and non-member of the Exchange, but unlike *Paine Webber*, the non-member is the alleged victim of the member's conduct, and the dispute *is* related to the member's exchange activities. In our view the instant dispute is arbitrable. Accordingly, we reverse.

BACKGROUND

Spear, Leeds—as a registered futures commission merchant and a member of the NYSE—agreed upon joining the NYSE to act in accordance with its Constitution and Arbitration Rules. The three life insurance companies defendants are not members of the Exchange, but have demanded arbitration pursuant to the Exchange's Constitution and Rules. *See Spear, Leeds & Kellogg v. Central Life Assurance Co.*, 879 F. Supp. 403 (S.D.N.Y.

1995). In order to understand the legal issues raised on this appeal, a brief discussion of the underlying facts is necessary.

I Facts

Spear, Leeds opened an account and several subaccounts on behalf of Marvin Goodman in November 1990. Goodman, previously a customer of Balfour Maclaine Futures, Inc. (another registered futures commission merchant), was reputed to be a successful commodities trader, trading for his own account, for his family, and for a rather sizeable select group of clients. When a background check disclosed no financial or regulatory problems associated with Goodman, Spear, Leeds accepted him as a customer.

Goodman's clients' accounts were listed on Spear, Leeds records as "sub-accounts" of Goodman's account. As such, the accounts were charged a lower commission rate. Professing concern that should he die suddenly, delays in the probate of his estate might create certain risks in his sub-account arrangement, Goodman purchased life insurance and put it in irrevocable trusts so that upon his death his clients would immediately be paid the equity balances in their accounts. At the end of 1990 the trusts held $20 million of life insurance on Goodman's life.

Because of his expanding commodity trading business, Goodman set out in 1991 to augment this life insurance plan. The three insurance companies were persuaded to issue additional life insurance policies totalling $3 million. To obtain this additional insurance Goodman was required to explain his method of trading and why he needed additional insurance. Thus, he provided defendants with detailed financial information regarding his accounts at Spear, Leeds. Defendants were shown the broker's account statements with significant positive account balances—between $17.5 and $20.5 million dollars.

Goodman's plans for the protection of his clients' financial security did protect them on his untimely death,

but for the defendant insurance companies, Goodman's plans proved to be fraudulent. *See Spear, Leeds*, 879 F. Supp. at 404. And, according to the defendants, Spear, Leeds played a vital role in helping Goodman defraud them. The broker generated and mailed monthly account statements to Goodman and his clients. These account statements—subsequently provided to the insurance companies by Goodman—provided a basis for them to extend the additional insurance to Goodman.

According to the defendants, the monthly profits noted in the sub-account statements were illegitimate, a reflection of "arbitrary and concocted directions" from Goodman that bore no relation to his actual trading. The insurance companies further allege that the broker made numerous errors in maintaining its account records. It did not segregate the balances of Goodman's sub-accounts, as shown on the face of the statements, and instead listed the accounts on a "net basis." This resulted in substantial overstatements of actual account balances. Because the accounts were carried on a "net basis" rather than a "gross basis," defendants never learned Goodman's true financial status before issuing the life insurance policies. Hence, Spear, Leeds is charged by defendants with preparing and mailing misleading and false monthly statements that obscured Goodman's trading activities and the reality of his financial condition.

In August 1991 the NYSE, while conducting a routine investigation, discovered Goodman's fraud. Jeffrey Zinn, an Exchange investigator, was alerted by the unusual number of sub-accounts (approximately 86) that Goodman had with Spear, Leeds. The broker stated it knew only of Goodman's interest in the accounts, but it acknowledged mailing statements concerning the many sub-accounts to others. Although Spear, Leeds had the names and addresses for mailing purposes, it maintained no opening account documents establishing these sub-accounts. The broker stated that Goodman was its cus-

tomer—not the sub-account parties—and conceded that his total account balance was actually closer to $2 million than the $17-$20 million presented to defendants by Goodman.

The Commodity Futures Trading Commission (Commission) also instituted an enforcement action and froze Goodman's assets. On December 17, 1991, before the conclusion of the Commission's proceedings, Goodman died. Accordingly, under the terms of the insurance trusts, Goodman's investment clients received payments from the insurance companies equal to the equity the clients thought they had in the Spear, Leeds sub-accounts. Defendants argue that these insurance monies saved Goodman's clients, the individual victims of the fraud, from any loss, and in fact provided them with a windfall.

II Procedural History

These developments led to three actions between Spear, Leeds and the insurance companies. First, the insurance companies filed an arbitration claim before the NYSE on December 15, 1993, seeking to recover against Spear, Leeds in accordance with the NYSE Constitution and Rules. The essence of that claim is that the broker participated in Goodman's fraudulent scheme by issuing false and misleading account statements to Goodman and his customers. Because the insurance companies would not have issued the life insurance policies without these favorable account statements, they asserted, their losses were directly caused by the broker's actions. The statement of claim seeks relief on the basis of common law theories—principally negligence and fraud—as well as under 18 U.S.C. § 1962(a), (c), (d) (civil RICO), pointing to specific findings made by the NYSE in the course of its investigation. It refers to Spear, Leeds' violations of NYSE rules and its consent to the imposition of a $75,000 fine and a censure by the NYSE. The Commission also reached an agreement with Spear, Leeds under

which the broker consented to a $325,000 penalty and its managers were fined and suspended for their activities in connection with Goodman's account. The three insurance companies sought damages totalling just over $1.9 million.

In order to avoid arbitration, plaintiff filed the instant action in the Southern District of New York and moved for a preliminary injunction enjoining the insurance companies from compelling arbitration. A week later, the insurance companies instituted an action in the United States District Court for the District of Nebraska (the situs of the proposed arbitration) seeking to compel arbitration under the Federal Arbitration Act (FAA), 9 U.S.C. § 4 (1994). On March 9, 1994 the parties agreed to stay the Nebraska action and to be bound by the arbitrability determination in the New York action now before us.

The district court decided the case on March 30, 1995. It found no contract to arbitrate, and that in its absence and the absence of any transactional nexus between Spear, Leeds and the insurance companies, compelling arbitration would be inappropriate. *See Spear, Leeds*, 879 F. Supp. at 406. From the order granting an injunction staying arbitration, the insurance companies appeal.

DISCUSSION

Historical Background

Jurisprudence in the securities field has stressed the long history of self-regulation of the stock exchanges. *See, e.g., Silver v. NYSE*, 373 U.S. 341, 349-57 (1963). Before the advent of federal securities law the various stock and commodity exchanges functioned like private clubs, exercising internal discipline with little political or judicial oversight. In the 1700s, the lack of oversight led to scandals like the South Sea Bubble, in which thousands of English and French investors were ruined. Louis Loss & Joel Seligman, *Securities Regulation* 1-2

(3d ed. 1995). Unscrupulous persons in this country in the 1800s sold securities and land to gullible investors, like Martin Chuzzlewit, who thought he was buying into a new and growing American metropolis called the Valley of Eden, but whose investment turned out to be one in a dense forest located in a poisonous swamp. Charles Dickens, *Martin Chuzzlewit* (Part One) 443-464 (Peter Fenelon Collier & Son 1900) (1844). Similar conduct early in the present century, together with the increasingly important role of the national exchanges in the nation's economy, made ungoverned self-regulation and the private club analogy inadequate and inapposite. *See Silver*, 373 U.S. at 351.

To respond to this inadequacy and the grave consequences attending it, Congress enacted securities laws allowing enhanced government supervision of national exchanges. But the new government role did not displace the tradition of self-regulation; Congress' aim was to have the exchanges take the lead, with the government in reserve. In other words, " '[g]overnment would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.' " *Silver*, 373 U.S. at 352 (quoting Douglas, *Democracy and Finance* 82 (Allen ed. 1940)). One aspect of the securities laws' design therefore was for the exchanges to play a major role in curbing abuses by obligating them to regulate themselves. This required the exchanges to formulate rules governing exchange members' activities and conduct. *Id.* at 353. An unavoidable side-effect is that enforcement of such rules inevitably "sweep[s] . . . nonmembers into the currents of the Exchange's process of self-regulation." *Silver*, 373 U.S. at 356.

I The Arbitration Agreement

With this background in mind, we pass to the merits. Whether or not a matter is arbitrable is a matter for judicial determination. *See AT&T Technologies, Inc. v. Communications Workers*, 475 U.S. 643, 649 (1986); *see also*

First Options of Chicago, Inc. v. Kaplan, 115 S. Ct. 1920, 1924 (1995) (holding that questions of arbitrability are decided by courts unless a contract unmistakably provides otherwise).

It is established law that the issuance of a preliminary injunction is to be reversed only when we conclude that the district court abused its discretion by applying incorrect law, basing its decision on a clearly erroneous finding of fact, or making an error in the substance or form of the injunction it issued. *See Coca-Cola Co. v. Tropicana Prods., Inc.*, 690 F.2d 312, 315 (2d Cir. 1982). It is equally familiar law that a party seeking a preliminary injunction

> must demonstrate (1) irreparable harm should the injunction not be granted, and (2) either (a) a likelihood of success on the merits, or (b) sufficiently serious questions going to the merits and a balance of hardships tipping decidedly toward the party seeking injunctive relief.

Able v. United States, 44 F.3d 128, 130 (2d Cir. 1995) (per curiam) (quoting *Resolution Trust Corp. v. Elman*, 949 F.2d 624, 626 (2d Cir. 1991); *see also Jackson Dairy, Inc. v. H.P. Hood & Sons, Inc.*, 596 F.2d 70, 72 (2d Cir. 1979) (per curiam). There is no doubt that an injunction in the case at hand would be necessary to prevent *per se* irreparable harm if, as the district court believed, the plaintiff would otherwise be compelled to arbitrate a claim it never agreed to arbitrate. *See PaineWebber Inc. v. Hartmann*, 921 F.2d 507, 515 (3d Cir. 1990). Consequently, our analysis concerns the second part of the preliminary injunction showing.

Our initial task is to determine whether Spear, Leeds entered into an agreement to arbitrate. Only when an agreement to arbitrate is found to exist does a court proceed to decide whether a given dispute falls within the scope of that agreement. These two inquiries are separate and independent. *Cf. McMahan Sec. Co. v. Forum*

Cap. Mkts. L.P., 35 F.3d 82, 86-89 (2d Cir. 1994); *Haviland v. Goldman, Sachs & Co.*, 947 F.2d 601, 604 (2d Cir. 1991), *cert. denied sub nom. J. Aron & Co. v. Haviland*, 504 U.S. 930 (1992).

The district court focused on whether any relationship existed between Spear, Leeds and defendants. It looked for some nexus, such as an agreement, some sort of transaction, or a relationship involving Spear, Leeds and the insurance companies. It found none. The district court concluded that the absence of such a nexus was fatal to defendants' case. *See Spear, Leeds*, 879 F. Supp. at 405. It therefore held that Spear, Leeds had never agreed to arbitrate any disputes between itself and the life insurance companies. The trial court went on to hold that the test for granting a preliminary injunction was satisfied because plaintiff would suffer irreparable harm if it were required to arbitrate without having agreed to do so, and because the absence of an agreement to arbitrate demonstrated a likelihood of Spear, Leeds' success on the merits.

While it is true that the broker and defendants never directly contracted with one another, we have explained that the arbitration rules of a securities exchange are themselves "contractual in nature." *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Georgiadis*, 903 F.2d 109, 113 (2d Cir. 1990). Because Spear, Leeds is a NYSE member, the appropriate question is whether defendants can invoke the Exchange Rules as third party beneficiaries. To answer this question we must examine the NYSE Constitution and Rules.

As pointed out earlier, by joining the New York Stock Exchange, Spear, Leeds agreed to abide by the Exchange's Constitution and Arbitration Rules. The Constitution provides that "any controversy between a member . . . and any other person arising out of the business of such member . . . shall at the instance of any such party be submitted for arbitration." NYSE Const. art. XI, § 1. Rule 600(a) of the NYSE Arbitration Rules further states

> Any dispute, claim or controversy between a . . . non-member and a member . . . arising in connection with the business of such member . . . shall be arbitrated under the Constitution and Rules of the [NYSE] as provided by any duly executed and enforceable written agreement or upon the demand of the . . . non-member.

Hence, the Rules create enforceable contract rights for non-members in certain specified circumstances. No agreement is required between the parties to the arbitration before a non-member may invoke Rule 600(a). Rather, Rule 600(a) explicitly provides that a "demand" by a non-member is an alternative basis for arbitration, separate from a "duly executed and enforceable written agreement" providing for arbitration.

This reading is bolstered by prior decisions that make clear that "the arbitration rules of an exchange are sufficient to compel arbitration of exchange-related disputes *in the absence of a specific written arbitration agreement.*" *Georgiadis*, 903 F.2d at 113; *see also Paine, Webber*, 728 F.2d at 580 (arbitration provisions of the NYSE Constitution and Rules are sufficient in and of themselves to compel arbitration of covered disputes regardless of whether they are incorporated in a separate agreement). We have also held—in the context of the National Association of Securities Dealers (NASD) Code—that a third party can rely on a similar rule to compel arbitration of a dispute with a NASD member. *See Kidder, Peabody & Co. v. Zinsmeyer Trusts Partnership*, 41 F.3d 861, 864 (2d Cir. 1994); *cf. Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 25 n.2 (1991) (requiring arbitration between a NYSE member and a registered securities representative (a non-member) on the basis of an agreement with a third party—the stock exchange). Hence, decisional law recognizes that the FAA requires the enforcement of an arbitration agreement not just in favor of parties to the agreement, but also in favor of third party beneficiaries of the members' agreement to abide by the

Exchange's Constitution and Rules when they join the NYSE.

The dissenting opinion relies on *Wheat, First Securities, Inc. v. Green*, 993 F.2d 814 (11th Cir. 1993) in opposition to the third party beneficiary approach used here. However, *Wheat* is not good law in our Circuit, as it questions *Paine, Webber*, one of our first occasions to invoke third party beneficiary theory in this context. *See Wheat*, 993 F.2d at 820 (noting that *Paine, Webber*, raises a "tantalizing question"). Naturally, we do not consider the matter open for further debate; third party beneficiary theory is the law.

Therefore, we believe the insurance companies are entitled, as third party beneficiaries of an arbitration agreement, to insist on arbitration.[1] Spear, Leeds and our dissenting colleague seem to argue that because the parties in many of the prior decisions happened to have contractual relationships, these precedents are not controlling in this petition for arbitration of tort claims including fraud and negligence. But there is no principled reason why the instant tort claims are not susceptible to the same sort of analysis used for contract claims. The insurance companies, as beneficiaries of the contract entered into by Spear, Leeds, are not limited to a contract cause of action before the arbitrators. Although in *Paine, Webber*, 728 F.2d at 581, we held that the NYSE

---

[1] Our dissenting colleague incorrectly asserts that we believe the insurance companies are "third party beneficiaries of the settlement of the life insurance payments on Goodman's death to the designated beneficiaries of the life insurance that Goodman purchased." (dissent, at 2). As just noted, the insurance companies are third party beneficiaries to the contract between SLK and the NYSE. Further, we are not attempting to place the insurance companies in "Goodman's shoes," as the dissent alleges. Although the insurance companies briefly made a similar argument to the district court, they did not rely on this argument on appeal, and at any rate, the argument plays no role in our analysis. Therefore, the dissent's multiple references to equitable subrogation are inapposite.

Rules did not cover a particular dispute between a member and a non-member, we did imply that those rules could serve as an agreement to arbitrate some tort claims, including common law fraud and negligent misrepresentation. *See id.* at 578, 580. In *Fleck v. E.F. Hutton Group, Inc.*, 891 F.2d 1047, 1048, 1054 (2d Cir. 1989), we stated that Rule 600(a) might require a NYSE "associated person" to arbitrate a tort dispute with a non-member at the non-member's request even though the alleged torts were committed months after the litigants' contract terminated. And, in *Gilmer*, 500 U.S. at 23, arbitration of a claim under the Age Discrimination in Employment Act (ADEA), akin to a tort claim, was required.

Aside from these cases, the express language of Rule 600(a) does not require a contract between parties to a controversy as a precondition to arbitration, nor does it limit the scope of arbitration to contractual questions. It simply requires a non-member's demand for arbitration of a claim that concerns the business of a member. Indeed, tort law may be where non-members most need NYSE protection because parties contracting directly with NYSE members always have the option to include an arbitration clause in their contract, thereby making clear under what circumstances arbitration may be invoked. Victims of an Exchange member's tort, on the other hand, may lack the luxury of that option.

It may frequently be the case that non-members making allegations of wrongdoing prefer to litigate tort disputes in court because of the protections of the jury system and the frequent unavailability of certain remedies in arbitration, for example, punitive damages. *See, e.g., Barbier v. Shearson Lehman Hutton Inc.*, 948 F.2d 117, 122 (2d Cir. 1991). But this preference by many for a judicial forum does not mean that arbitration is unavailable as a forum for those who, like the insurance companies, choose it.

Although the trial court held that defendants failed to show a transactional nexus between themselves and plaintiff sufficient to warrant arbitration, *see Spear, Leeds*, 879 F. Supp. at 406, defendants' lack of direct contact with plaintiff does not prevent them from asserting their rights as third party beneficiaries. While identification of a beneficiary may help resolve whether he is an intended or an incidental beneficiary, *see* Restatement (Second) of Contracts § 308 cmt. a (1981), a beneficiary need not be identified prior to seeking enforcement of its rights under a contract. *See Owens v. Haas*, 601 F.2d 1242, 1250 (2d Cir.), *cert. denied sub. nom County of Nassau v. Owens*, 444 U.S. 980 (1979); Restatement (Second) of Contracts § 308 (1981).

Neither a transactional nexus between plaintiff and defendants, nor identification of these specific defendants as third party beneficiaries, is required to compel Spear, Leeds to arbitrate a dispute in accordance with NYSE procedures. Thus, the NYSE's Arbitration Rules provide a sufficient basis for finding the necessary agreement to arbitrate defendants' claims as prescribed by § 4 of the FAA.

II Scope of the Agreement

A. *Principles of Arbitrability*

Having answered the initial question of whether Spear, Leeds entered into an agreement to arbitrate in the affirmative, we turn to the second inquiry: whether the present dispute between plaintiff and defendant falls within the scope of that agreement. Certain understandings govern any discussion of arbitrability. First, and most importantly, "as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration." *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983). Another way of expressing this is to say that arbitration must not be denied unless a court is positive that the clause it is examining does not cover the asserted dispute. *See AT&T Technologies*, 475 U.S. at 650.

Second, because we are interpreting a contract, our construction must ascertain and implement the reasonable expectations of the parties who undertake to be bound by its provisions. *See Leadertex, Inc. v. Morganton Dyeing & Finishing Corp.*, 67 F.3d 20, 29 (2d Cir. 1995). Despite the presumption of arbitrability, the strong federal policy favoring arbitration may not extend the reach of arbitration beyond the intended scope of the clause providing for it. *See Fuller v. Guthrie*, 565 F.2d 259, 261 (2d Cir. 1977).

Third, analysis may not intrude on the merits of the insurance companies' claims against the broker. After all, the NYSE Rules constitute an agreement "to submit all grievances to arbitration, not merely those which the court will deem meritorious." *United Steelworkers v. American Mfg. Co.*, 363 U.S. 564, 568 (1960). An assessment of the merits of the case would run afoul of this principle. Although the district court and our dissenting colleague apparently were unimpressed with the merits of defendants' theories of plaintiff's liability, the validity of defendants' legal argument is not pertinent to the present inquiry.

B. *Exchange-Relatedness*

With these precepts in mind, we undertake to determine whether the dispute between Spear, Leeds and the insurance companies is within the scope of the NYSE provisions. According to Rule 600(a), the broker must, upon the demand of a non-member, arbitrate claims or controversies that "aris[e] in connection with the business [of the broker]." This language has been frequently interpreted. In *Paine, Webber*, 728 F.2d at 580, for example, we explained that when the alleged improper conduct is on the part of the non-member, only those controversies "arising out of the member's exchange-related business" must be arbitrated.

We offered two reasons for this view. The first reason is that the NYSE Rules require disputes between members to be arbitrated when they concern "any controversy," whereas in the context of a member-non-member dispute there is the additional requirement that the dispute arise in connection with the member's business. By reading this language as prescribing that the controversy be exchange-related, we avoid the anomaly of having two differently worded rules that are construed as having the same meaning. Hence, the exchange-relatedness requirement allows us to enforce faithfully the parties' expectations by providing a more restrictive scope for the member-non-member provisions than for intramural disputes. *Id.* at 580.

The second reason is that to extend Rule 600(a) to cover controversies not arising out of exchange-related business between members and non-members would work a substantial injustice with respect to the reasonable expectations of Exchange members. It would require a member, upon a non-member's demand, to arbitrate any dispute. We do not believe that members could reasonably be said to have anticipated such a result. *Id.* at 580-81.

At any rate, all of this is settled law, and were we faced with a case involving a non-member's attempt to compel a member to arbitrate a claim of non-member wrongdoing, our path would be clear: If the claim involved the member's exchange-related business, we would compel arbitration. However, whether a member accused of wrongdoing might be compelled to arbitrate even when the controversy does *not* involve exchange-related business was a question left open in *Paine, Webber.* We speculated in that case that the mandate of self-regulation Congress imposed on the NYSE and other exchanges might permit a broader reading of Rule 600(a) in this different context. *Id.* at 580 n.5.

Both parties have briefed and argued this unresolved question. Defendants point to two cases from other courts, decided after *Paine, Webber*, that find no requirement for exchange-relatedness in similar circumstances. In *Pearce v. E.F. Hutton Group, Inc.*, 828 F.2d 826, 832 (D.C. Cir. 1987), it was held that while it would be anomalous for a non-member accused of wrongdoing to invoke the benefits of a NYSE arbitration when its actions did not involve exchange business, there was no anomaly in compelling an exchange member accused of wrongdoing to participate in a NYSE arbitration. The New York Court of Appeals reached a similar conclusion, noting that the strong policy reasons behind the placement of an exchange-relatedness gloss on the literal language of Rule 600(a) did not apply in this different context. *Nomura Sec. Int'l, Inc. v. Citibank, N.A.*, 81 NY2d 614, 620 (1993).

However, we decline the invitation to decide if Rule 600(a) demands that the non-member show exchange-relatedness, and leave open this question originally posed in *Paine Webber*. Instead, because we are persuaded that the controversy at hand does in fact arise out of Spear, Leeds' exchange-related business, we need not decide whether the defendants could have had their dispute arbitrated, were it not exchange-related.

C. *Instant Controversy Exchange-Related*

Several considerations persuade us that the facts of this controversy arise out of plaintiff's exchange-related business. Although in deciding arbitrability, as earlier noted, we do not consider the merits of the defendants' claims or the ultimate likelihood that they will succeed at arbitration, examination of their claims reveals that matters concerning the NYSE are implicated. The insurance companies argue that absent plaintiff's wrongdoing in supervising Goodman's accounts, they would not have suffered a loss. They point to violations of various NYSE rules, including Rule 401 (members must adhere

to principles of good business practice) and Rule 342(b) (members must institute supervisory controls and internal review systems), and conclude that the violation of these rules led to their injury. While an alleged violation of exchange rules will not always allow a dispute to be the subject of a NYSE arbitration, it does strongly support a conclusion of exchange-relatedness. The NYSE obviously considered plaintiff's actions exchange-related. This is evidenced by the investigation and the subsequent consent agreement. It also belies the dissent's suggestion that the NYSE would likely consider this matter "remote" (dissent, p.8 n.2) or unrelated to its regulatory responsibilities. In *Pearce*, the D.C. Circuit found it significant in its analysis that the NYSE investigated the member concerning the controversy that the non-member sought to arbitrate. *Pearce*, 828 F.2d at 831 n.2.

Further, because plaintiff entered into a consent agreement with the NYSE as a result of the investigation, it is more difficult for it to argue that the dispute with defendants is not exchange-related. The NYSE concluded that plaintiff violated Exchange Rule 401, which requires members to "adhere to the principles of good business practice in the conduct of [their] business affairs." The NYSE also found a violation of Rule 342(b) based on plaintiff's failure to "provide for appropriate supervisory control" and to "establish a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised." In *Paine, Webber*, 728 F.2d at 581, we observed that "the substantial interest of the exchange in the sound and proper management of its member firms justified . . . arbitration." The defendants' claim here is partly based on the broker's improper management practices. It is also of some relevance that we pointed to disputes concerning Rules 401 and 342(b) as examples of "internal matters that . . . receive the watchful attention of the exchange" that would likely be deemed exchange-related. *Id.* at 581 & n.7.

The Exchange's findings arose out of plaintiff's actions relating to Marvin Goodman and his numerous sub-accounts. The Exchange ruled that plaintiff "failed to maintain any new account documentation or other records with respect to the individuals named in the Dual Name sub-accounts although they were receiving duplicate sub-account statements." The report of the Exchange's hearing panel makes clear that Spear, Leeds never verified Goodman's explanation for establishing so many sub-accounts, nor did plaintiff or its managers investigate numerous other unusual aspects of Goodman's trading. While not passing on the merits of defendants' claims against plaintiffs, that they arise out of the same alleged wrongdoing that the NYSE investigated lends support to a conclusion of exchange-relatedness. We briefly note that despite the dissent's contention, the payment of death benefits by the defendants to Goodman's clients in no way contributed to our finding of exchange-relatedness (dissent, p.2). Our conclusion rests instead on the reasons just articulated.

Any doubts that may remain as to the arbitrability of this controversy must be resolved in favor of arbitration because of the strong presumption discussed earlier favoring that forum. Moreover, obliging a NYSE member to arbitrate a dispute so closely connected with behavior investigated and punished by the exchange may hardly be said to violate a member's reasonable expectations. *Cf. Leadertex*, 67 F.3d at 29. While plaintiff might not have known the specific parties that would be harmed by its violation of Exchange rules, it should reasonably have expected that a failure to obey NYSE rules would lead a party aggrieved by its conduct to seek arbitration of a claim arising from it. Our decision today also strengthens the presumptive partnership between courts and the national exchanges by allowing and facilitating vigorous self-regulation. *See Silver*, 373 U.S. at 352; *Paine Webber*, 728 F.2d at 581.

For all of these reasons, the instant controversy is exchange-related. As members should reasonably expect to be haled before an Exchange arbitration when their conduct violates Exchange rules and leads to Exchange investigations and penalties, we are implementing the reasonable expectations of the parties. Even if the narrower scope of the NYSE Rules governing arbitration between members and non-members warrants an "exchange-related business" requirement, the strong policy favoring self-regulation by exchange members suggests that a broad set of disputes are exchange-related when the NYSE member is the actor against whom arbitration is sought.

CONCLUSION

Accordingly, in light of our conclusion that the instant controversy falls within the scope of a valid arbitration agreement, it necessarily follows that plaintiff has shown neither a likelihood of success on the merits, nor a sufficiently serious question going to the merits along with a balance of hardships tipping decidedly toward it to warrant the grant of a preliminary injunction barring arbitration. The order enjoining arbitration is therefore reversed and the case remanded to the district court for further proceedings not inconsistent with this opinion.

POLLACK, *Senior District Judge*, dissenting:

I respectfully dissent.

The defendants herein, insurance companies, were enjoined from seeking arbitration before the New York Stock Exchange of their claims against SLK, the appellee. The majority lifts that injunction.

Marvin Goodman was a floor broker on the Commodity Exchange and was a member of the NYSE. He solicited individuals to trade gold and silver commodity futures contracts. He traded those customers' accounts

through sub-account arrangements with SLK who handled the mechanics and cleared the transactions in those "Goodman" accounts.[1]

Some of his customers gave money to Goodman to finance their trades. To save his clients from loss from his advice and trading, Goodman purchased and himself paid for insurance on his life through the appellants, naming his clients in an insurance trust as beneficiaries of the life insurance. Goodman died and the Goodman clients collected the life insurance.

The insurance companies then filed arbitration claims with the New York Stock Exchange against SLK the clearing broker seeking a recovery from the clearing broker of the life insurance which they had paid to Goodman's customers. The insurance companies charged that Goodman was guilty of fraud on his personal customers and that SLK had furnished incomplete or doctored statements of account to those customers and had thereby assisted Goodman in his fraud on his customers. Goodman's customers are making no claim.

SLK sued to enjoin the attempted arbitration on the ground that it was not obligated to arbitrate any claims of the insurance companies and the district court entered an injunction against the attempted arbitration proceedings. The insurance companies appealed.

The NYSE arbitration rules are applicable in respect of any dispute between a member brokerage firm and

---

[1] SLK received commissions on every trade and would split the interest in Goodman's account on a monthly basis. SLK created approximately 69 accounts under a primary account number in Goodman's name labelled "7260 MG MOO" ("primary account"). At least three other accounts were also in Goodman's name and were labelled with names such as "Goodman Arbitrage." The remaining accounts were set up as "sub-accounts" under the 7260 account number, i.e., 7260-7283, and were listed under the hyphenated name of Goodman and a Goodman customer.

any third party *"arising out of"* or *"in connection with"* the firm's *"business"*. It is undisputed that the insurance companies had no business or connection or communication whatsoever with the clearing brokers and were not furnished by SLK any statements of account applicable to Goodman's clients and did not request any information whatsoever from SLK. In short, the insurance companies did no due diligence so far as concerns SLK or in any way inform it that they were selling life insurance to Goodman for the protection of his personal customers.

To obtain the arbitration which the District Court enjoined, the Insurers claim that SLK acted wrongfully in the handling of Goodman's sub-accounts with his customers' accounts. They assert that even if SLK did not deal directly with the Insurers, and had no part in the procurement and payment by Goodman for insurance on his life for the benefit of his customers, that by mishandling of Goodman's accounts, SLK was a proximate cause of the Insurers' "losses" and that SLK thus collaborated with Goodman in "defrauding" the Insurers. The insurance companies obtained life insurance premiums from Goodman on the life insurance and paid the beneficiaries designated for those premiums.

The majority reaches its conclusion that the insurance companies are entitled to demand arbitration with SLK by the NYSE on the reasoning that the payment of the death benefits under the life insurance policies "aris[es] out of the business," NYSE Const., art XI, § 1, or "aris[es] in connection with [its] business." NYSE Arbitration R 600(a). The majority rests this result on the notion that the Insurers were or are intended third party beneficiaries of the settlement of the life insurance payments on Goodman's death to the designated beneficiaries of the life insurance that Goodman purchased.

It seems appropriate to recite what the record shows which makes clear beyond peradventure of doubt that the

life insurance companies are in no way third party beneficiaries of any claim against SLK and that neither the sale of the insurance to Goodman nor payment of the death benefits to the trust for the named beneficiaries constituted the Insurers third party beneficiaries of any claim thereon against SLK.

The controversy at issue does not even remotely arise out of SLK's exchange-related business; it concerns insurance policies which Goodman purchased and personally paid for to benefit his customers in the event of his death, by providing for protection from delays of probate in the event of his death. The trustees of the insurance trust created by Goodman were to pay the proceeds first to the persons who had given Goodman money for him to trade (since the account was in Goodman's name, these individuals would otherwise not be paid until Goodman's estate was probated), and to hold the remainder in continuing trust for Goodman's heirs.

Plainly, the Insurers are not presenting an exchange-related dispute in which either Goodman or his customers make claim or are parties. The life insurers are not third party beneficiaries to the contract between SLK and the NYSE rule governing arbitration which provides that "any controversy . . . between a member . . . and any other person arising out of the business of such member" shall be submitted to arbitration. Neither SLK nor the NYSE could ever have intended to benefit with Exchange arbitration, unrelated life Insurers which sold estate planning and the insurance benefits to Goodman, a customer of SLK, the brokerage firm, without any participation or input whatsoever of SLK, on the notion that the Insurers had thus achieved a third party status under the arbitration agreement between the Exchange and its members.

Moreover, any attempt to place the life Insurers "in the shoes of" Goodman must fail. Equitable subrogation

or the equivalent, third party beneficiary status, does not exist for life insurance. Nor are the life Insurers able to invoke a third party beneficiary status based on the mere fact that there was a tort committed against them by Goodman, because third party beneficiary doctrine is applicable to contract, not tort, law.

In describing who are intended and incidental third party beneficiaries, the Restatement (Second) of Contracts § 302 teaches that:

> ". . . a beneficiary of a promise is an intended beneficiary if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties and either (a) the performance of the promise will satisfy an obligation of the promisee to pay money to the beneficiary; or (b) the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance."

It is undeniable that SLK did not "intend" or in fact or in law confer an arbitrable right on the Insurers of Goodman's life or intend to reimburse life insurance proceeds paid by the Insurers in accordance with the policy which it wrote. The life insurance was obtained and paid for by Goodman without the knowledge or participation of SLK, to facilitate payment of death benefits promptly without waiting on the administration of Goodman's estate; it bore no relation at all to SLK.

To summarize for the sake of any needed further clarification:

We are asked to compel a member of the NYSE to arbitrate a possible tort claim asserted by life Insurers which wrote life insurance on the life of one, Goodman, a customer of SLK, as part of his estate planning, for the benefit of Goodman's customers, payable to a trust for their benefit. The Insurers had no contact or business of any kind with SLK and made no inquiries of SLK. The

Insurers wrote the life policies for, and dealt with Goodman, but never transacted any business with SLK. By virtue of joining the NYSE, SLK agreed to arbitrate only the business claims of any person who asserted a claim against SLK in connection with some business conducted by or with SLK by that person.

SLK never came in contact with the Insurers/appellants, never made any representations to the latter, never sent any documents or communications whatsoever to appellants, had no knowledge of the dealings of Goodman resulting in the life insurance and did not provide appellants with any ground on which they could reasonably believe that appellants were obtaining or could assert an arbitrable right against SLK for the sum paid out on the life insurance written for the benefit of Goodman's customers. The Insurers never contacted SLK regarding Goodman's insurance applications, his SLK account statements or anything else. To compel SLK to arbitrate with the Goodman Insurers would violate the basic principle that a party cannot be compelled to arbitrate with one with whom there is no business connection, or any contract to do so directly or by inference. The life insurance on Goodman's life did not arise in connection with any business between the life insurance companies and SLK.

Again, there was no transaction between the member and non-members, who were strangers to one another. As the Eleventh Circuit recently held in an analogous NASD context, the fact that the non-member and member "had absolutely no relationship" to each other "at the time of the alleged events that the [non-member] seek[s] to arbitrate", affords a "compelling basis" for the conclusion that the member could not be deemed to have agreed to arbitrate with a non-member stranger. *Wheat, First Securities, Inc. v. Green*, 993 F.2d 814, 818 (11th Cir. 1993).

"[A]rbitration is a matter of contract and a party cannot be required to submit to arbitration any dispute out-

side the scope of the business conducted or involving the estate planning undertaken by life insurers with another he has never agreed so to submit". *United Steelworkers of America v. Warrior and Gulf Navigation Co.* 363 U.S. 574, 582 (1960). *See also, Thomson-CSF, S.A. v. American Arbitration Assoc.*, 64 F.3d 773, 779 (2d Cir. 1995). Congress, in enacting the Federal Arbitration Act, preserved this principle. *See Volt Information Sciences, Inc. v. Board of Trustees of the Leland Stanford Junior Univ.*, 489 U.S. 468, 478 (1989) ("The FAA does not require parties to arbitrate when they have not agreed to do so".) While we have held that the NYSE arbitration provisions may require a party to submit to arbitration in the absence of a written agreement, *see, e.g., Paine, Webber, Jackson & Curtis v. Chase Manhattan*, 728 F.2d 577, 580 (2d Cir. 1984), we have never extended this principle to require the member to submit to arbitration of claims outside the member's chain of commerce. Here it is clear that SLK did not "intend", in fact or law, to reimburse life insurance payments made by the Insurers to customers of the deceased on policies of insurance with which SLK had no connection, which were obtained by Goodman for prompt administration of his estate and bore no relationship to SLK at all. Goodman's customers are not claimants against SLK.

The majority's reliance on *Kidder, Peabody & Co. v. Zinsmeyer Partnership*, 41 F.3d 861 (2d Cir. 1994) and *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991) is inapposite. *Kidder, Peabody* involved direct business contact between a broker and its customer and a written contract between those parties which specifically incorporated the NASD provisions and rules into it. In *Gilmer* the Supreme Court suggested that a third party, Interstate, could compel its ex-employee to arbitrate as a third party beneficiary of the business agreement between the ex-employee and the Exchange, but the agreement relied upon, Gilmer's securities registration application, specifically designated any of Gilmer's em-

ployees as beneficiaries to the agreement. Goodman's life insurance trust did not name SLK, his employer, as a beneficiary of the insurance trust. Nor does the NYSE's investigation into Goodman's activities or the procedural shortcomings of SLK for which they were fined, establish Goodman's life insurers as third-party beneficiaries entitled to admission into Exchange arbitration for recovery of the insurance payment to the intended and named legatees.

Finally the Insurers' payment on Goodman's policy does not entitle them to the arbitrable right formerly held by Goodman himself. There is no right of equitable subrogation under life-insurance. (16 Couch, *Cyclopedia of Insurance* § 61:8 2d rev. ed. 1983).

The record (A-197-98) contains an application on behalf of Goodman (unknown to SLK) to one of the insurers, explaining Goodman's motivation for purchasing life insurance, as follows:

> For trading purposes, all accounts are in Marvin Goodman's name. As you know, Marv wishes to have all account balances (all of which are traded under his name) liquid when he dies and not held up in probate which may take two years during which his clients will not have their money. Life insurance in some multiple amount of his capital base is very important to Marv for business as well as psychological reasons. He cannot take in new money without the assurance of ample protection since the account growth tends to diminish insurance rather quickly. As a result he always wants to be insured ahead of his anticipated needs (approximately 2x account balances).
>
> Once Marv's account balance meets his insurance total, he must stop growing which is counter productive. Marv's fee is based only on profits. We would like Mass Mutual Life to issue an additional $10 million of insurance. The insurance would be

owned by an irrevocable Trust to immediately liquidate all the client balances. The fact that this trust discharges an obligation (debt) of the estate creates a secondary need for funding the estate tax (1st death) that is attributed to the estate relative to the debt paid (see enclosure). This, of course, reduces the ultimate amount available to his family after probate.

The District Court Judge soundly observed that:

> "It is undisputed that Plaintiff [SLK] never had any direct contact or business transaction with Defendants [Insurers]." Goodman obtained the life insurance policies independently of Plaintiff and without Plaintiff's knowledge. Defendants do not claim there was any contractual relationship with Plaintiff. In fact, Defendants do not allege any contact with Plaintiff at all. Rather, Defendants claim that their reliance on falsified documents, whether by the fraudulent conduct of Goodman or that of Plaintiff, makes Plaintiff accountable to Defendants. . . . (A-927-28) '[A]ny rule extending the arbitration provisions to controversies not arising out of exchange-related business would do significant injustice to the reasonable expectations of exchange members . . .' *Paine, Webber*, 728 F.2d at 581. (A-927).

I would affirm.[2]

---

[2] The NYSE has refused to act as arbitrators in controversies remote from the business purposes and scope of arbitrable "exchange related" business controversies. *Cf. In re Salomon, Inc.*, 68 F.3d 554 (2d Cir. 1995)

Essential fairness to both parties is better served by leaving the administration of the unusual issues herein to judicial standards in the Courts rather than by straining to bring life insurance for estate planning within the scope of "exchange related" business for third parties to exchange agreements.

No matter how the semantics are arranged, the instant claims to recover life insurance payments made to Goodman's customers at his

death do not and cannot represent claims arising in connection with the business of Goodman's stockbrokers. The semantic allusions in the majority opinion to the "errors" in the minority opinion did not originate with the minority opinion, but a response would only further delay focussing on the merits of the life insurers' unsupportable third party concoction to gain an unmerited arbitration (even if it is safe for the majority to assume that the Stock Exchange would consider the convoluted claim for arbitration).

The notion of "arising out of exchange-related business" must be limited in some manner, lest *any* third party could compel an exchange member to arbitrate any claim, so long as some tenuous link to the member's "business" be alleged. This limitation should take the form of either a direct contract between the parties, or a relationship between the parties, such that they stand in the "chain of commerce," one with the other—situations which were present in all prior decisions invoking the third party beneficiary rule. *See Kidder, Peabody & Co. v. Zinsmeyer Trusts Partnership*, 41 F.3d 861 (2d Cir. 1994); *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991). The claims at issue here simply fail such a test. A tort claim based on reliance on an accounting statement not forwarded by the accountant to the injured party, will not state a claim at law. While this analysis goes to the merits of the insurers' underlying claim and not the question of arbitrability, a line must be drawn whereby claims that have such an invisible foundation in law will not be allowed to force an exchange member to arbitrate with a party with whom it had no contact or business.

APPENDIX B

UNITED STATES DISTRICT COURT
S.D. NEW YORK

No. 94 Civ. 0868 (KTD)

SPEAR, LEEDS & KELLOGG,
Plaintiff,

v.

CENTRAL LIFE ASSURANCE COMPANY, ALEXANDER HAMILTON LIFE INSURANCE COMPANY OF AMERICA, INC. and CANADA LIFE ASSURANCE COMPANY,
Defendants.

March 30, 1995

MEMORANDUM & ORDER

KEVIN THOMAS DUFFY, District Judge.

Plaintiff Spear, Leeds & Kellogg ("SLK") seeks a preliminary injunction against three life insurance companies: Central Life Assurance Company, Alexander Hamilton Life Insurance Company of America, Inc., and Canada Life Assurance Company, (collectively referred to as "Defendants"). Plaintiff seeks to enjoin Defendants from compelling Plaintiff to submit to arbitration. For the reasons stated below, Plaintiff's motion for a preliminary injunction is granted.

Plaintiff is a registered futures commission merchant and a member of the New York Stock Exchange ("NYSE" or "Exchange"). As such, is subject to the Constitution of the New York Stock Exchange ("NYSE Constitution")

and the Exchange Arbitration Rules ("NYSE Rules"). Defendants are life insurance companies who are not members of the NYSE. Pursuant the NYSE Constitution and Rules, Defendants filed an arbitration demand seeking recovery of monies they paid out on life insurance policies of a customer of SLK. Plaintiff claims that it is not subject to NYSE arbitration because it has no transactional nexus with Defendant, and therefore, the NYSE Constitution and Rules relied upon by Defendant do not apply.

Plaintiff opened a commodities account for Marvin Goodman in 1990. Prior to opening the account, SLK states that they conducted a background check on Goodman, and found no financial or regulatory problems. Plaintiff set up Goodman's account in the same way that Goodman's previous account with Balfour Maclaine Futures, Inc. ("Balfour"), also a NYSE member, was established. Goodman transferred his account from Balfour to Plaintiff. Goodman maintained various subaccounts with Plaintiff, all of which bore his name and social security number. Some of these subaccounts had debit balances and some had credit balances. According to Plaintiff, SLK sent these account statements on a regular basis to Goodman and to people specified by Goodman.

Goodman had also obtained life insurance policies from Defendants and others in excess of $23 million. Part of the applications for the life insurance required Goodman to supply Defendants with his financial statements. Apparently, Plaintiff's account statements were among those submitted by Goodman. Defendants supplied $3 million and upon Goodman's sudden death were required to pay $1.9 million to the policy beneficiaries. Many of the recipients of this money were clients of Goodman's for whom he had made various investments. Goodman apparently hid from his clients that their investments had lost money. According to Plaintiff, Goodman had been "doctoring" the account statements when he received them from SLK and sending out inaccurate statements to his clients. SLK alleges that they knew nothing of Goodman's

actions until after his death. Defendants allege that Plaintiff either falsified the documents or knew of the falsification and seeks to hold SLK liable for the amounts paid out on the insurance policies. To this end, Defendants filed a "Statement of Claim" in an arbitration demand with the NYSE. The instant action to enjoin arbitration followed.

DISCUSSION

The standard for granting a preliminary injunction is well settled in this Circuit. The plaintiff must show "(1) irreparable harm and (2) likelihood of success on the merits." *Reuters, Ltd. v. United Press Int'l, Inc.*, 903 F.2d 904, 907 (2d Cir. 1990) (quoting *Coca-Cola Co. v. Tropicana Products, Inc.*, 690 F.2d 312, 314-15 (2d Cir. 1982)). In the alternative, the plaintiff must show that there are "sufficiently serious questions going to the merits to warrant litigation and a balance of hardships in favor of the movant." *Roso-Lino Beverage Distributors v. Coca-Cola Bottling Co.*, 749 F.2d 124, 125 (2d Cir. 1984).

If a court determines that a valid arbitration agreement does not exist or that the matter at issue clearly falls outside the substantive scope of the agreement, it is obliged to enjoin arbitration. *PaineWebber Inc. v. Hartmann*, 921 F.2d 507, 511 (3d Cir. 1990). (hereinafter referred to as "*Hartmann*"). In the present case, there is no agreement between the parties, and thus, no arbitration clause to bind the parties. A party cannot be required to submit to arbitration any dispute which he has not agreed to so submit. *AT & T Technologies, Inc. v. Communications Workers of America, et al.*, 475 U.S. 643, 648, 106 S.Ct. 1415, 1418, 89 L.Ed.2d 648 (1986). A party so situated will suffer *per se* irreparable harm if a court compels the party to submit to arbitration when it has not agreed to do so. *See Hartmann*, 921 F.2d at 515. Never having agreed to arbitrate, SLK will suffer irreparable harm if it is forced to submit to arbitration.

The second factor to be considered on a preliminary injunction motion is whether Plaintiff has a likelihood of success on the merits. The determination of whether a matter is arbitrable is one to be made by the court. *Litton Financial Printing Division v. NLRB*, 501 U.S. 190, 208, 111 S.Ct. 2215, 2226, 115 L.Ed.2d 177 (1991). Both the Constitution and the Rules are clear and unambiguous as to the arbitration of disputes. The issue lies in whether there is a sufficient relationship between the member (Plaintiff) and the non-member (Defendants).

It is undisputed that Plaintiff never had any direct contact or business transaction with Defendants. Goodman obtained the life insurance policies independently of Plaintiff and without Plaintiff's knowledge. Defendants do not claim they were customers of Plaintiff.[1] Defendants do not claim there was any contractual relationship with Plaintiff. In fact, Defendants do not allege any contact with Plaintiff at all. Rather, Defendants claim that their reliance on falsified documents, whether by the fraudulent conduct of Goodman or that of Plaintiff, makes Plaintiff accountable to Defendants.

Defendants issued various life insurance policies to Goodman which named various trusts as the beneficiaries. Upon Goodman's death, Defendants paid the proceeds of the insurance to the trusts. The requirements of the trusts resulted in the money being paid to Goodman's customers. Defendants seek to hold SLK liable for the misdeeds of its customer. Whether Defendants claims have merit is not for me to determine. The matter before me involves solely the arbitrability of Defendants' claims.

In order for Defendants to compel Plaintiffs to submit to arbitration, they must show that the relationship between the parties is of the nature specified in the NYSE

---

[1] At one point in their brief, Defendants argue that they "stand in the shoes" of the customers, but this argument is unfounded. (Def.'s Mem. Opp'n Prelim.Inj. at 26); *see* 16 Couch, *Cyclopedia of Insurance* § 61:8 (2d rev. ed. 1983).

Constitution and the Rules. *See Paine, Webber, Jackson & Curtis, Inc. v. The Chase Manhattan Bank, N.A.*, 728 F.2d 577, 580 (2d Cir. 1984) (hereinafter referred to as "*Paine, Webber*"). The NYSE Constitution, art. XI, ¶ 1501, § 1 provides, in pertinent part:

> . . . any controversy between a member . . . and any other person arising out of the business of such member . . . shall at the insistence of any such party be submitted for arbitration in accordance with the provisions of this Constitution and such rules as the Board may from time to time adopt.

Id.

The Rules state substantially the same provision:

> (a) Any dispute, claim or controversy between a non-member and a member . . . arising in connection with the business of such member . . . shall be arbitrated under the Constitution and Rules of the New York Stock Exchange, Inc. as provided by any duly executed and enforceable written agreement or upon the demand of the non-member.

Id.

The question becomes whether the dispute between Plaintiff and Defendant "arises out of" the business of Plaintiff. This is a case of first impression and one that was expressly left open by the Court of Appeals in *Paine, Webber*. 728 F.2d at 580 n. 5. If the claims arise out of the business of Plaintiff, then the matter must be arbitrated. However, if it is determined that the claims do not arise out of Plaintiff's business, Plaintiff cannot be forced to submit to arbitration. Defendants base their claims on the fact that financial statements generated originally by Plaintiff were apparently supplied to them by Goodman. There is a question as to when the documents were altered. Defendants assert that the documents were prepared falsely by Plaintiff. Plaintiff states that it provided Goodman with accurate account statements, and that it

learned subsequently that the documents were altered and sent to Defendants.

Defendants mischaracterize the role of the NYSE Arbitration system. They cite to the presumption in favor of arbitration, and argue that the court should defer to the presumption. (Def.'s Mem.Opp'n Prelim.Inj. at 9); *see Pearce v. E.F. Hutton Group, Inc.*, 828 F.2d 826, 829 (D.C.Cir.1989). Defendants' reliance is misplaced. In *Pearce*, the Court applied the presumption due to the existence of an arbitration agreement between the parties. *Id.* The statement emphasized by Defendants that the NYSE is an example of an industry that effectively utilizes an arbitration system is accurate, but nonetheless is inapplicable to this situation. The *Pearce* court also noted that "arbitration is a creature of contract." *Id.* (citing *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 218, 105 S.Ct. 1238, 1241, 84 L.Ed.2d 158 (1984)). Given the absence of a contract between the parties, there is no presumption of arbitrability.

In determining the arbitrability of the claims, I look not to the merits of each party's case, but to the nature of the dispute and the people involved. The absence of any agreement whatsoever is fatal to Defendants' case. There is no indication that Plaintiff intended that the NYSE Constitution and Rules be applicable with regard to Defendants. This is because Plaintiff never transacted any business with any of the defendants. In fact, there is no indication that Plaintiff even knew that Goodman had obtained life insurance, much less be subject to arbitration of a dispute resulting therefrom. To rule otherwise would lead to the absurd: "[A]ny rule extending the arbitration provisions to controversies not arising out of exchange-related business would do significant injustice to the reasonable expectations of exchange members. Such a rule would require every exchange member, at the insistence of the nonmember, to submit to exchange arbitration every dispute it has with any entity in the world, no

matter what the subject matter." *Paine, Webber,* 728 F.2d at 581.

The arbitration provision contained in the NYSE Constitution and Rules which provides for arbitration between members and nonmembers has largely been applied in purchase and sale of securities. *See Paine, Webber,* 728 F.2d at 579, 580. In these cases, the NYSE Rules on Arbitration were incorporated by reference and made part of the agreements. *Id.* at 580. Here there is no agreement, no sale, and therefore no contractual obligation to arbitrate.

Plaintiff is bound to abide by the NYSE Constitution and Rules. However, it is not bound to Defendants in any way. The fact that Goodman supplied Defendants with incomplete or inaccurate financial statements does not rise to the level necessary to involve the creator of the original documents. In all its papers, Defendants do not once refer to the existence of any transaction or business with Plaintiff. I cannot find any relationship between the NYSE member and the nonmember, except that the nonmember was the insurance carrier of a customer of the member. There is no authority establishing the point at which a sufficient nexus is reached between the parties to warrant NYSE arbitration, but wherever that point may be, this situation is far from it. Accordingly, Plaintiff's motion for a preliminary injunction enjoining Defendants from compelling them to submit to arbitration is granted.

SO ORDERED.

APPENDIX C

[Filed July 17, 1996]

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the 17th day of July one thousand nine hundred and ninety-six.

Dkt No: 95-7372

SPEAR, LEEDS
Plaintiff-Appellee,

v

CENTRAL LIFE ASSURAN
Defendants-Appellants.

A petition for rehearing containing a suggestion that the action be *reheard* in banc having been filed herein by the appellee Spear, Leeds & Kellogg.

> Upon consideration by the panel that decided the appeal, it is Ordered that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges for the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

FOR THE COURT

GEORGE LANGE III
Clerk

By: /s/ Beth J. Meador
BETH J. MEADOR
Administrative Attorney

APPENDIX D

[Filed May 16, 1996]

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the 16th day of May, one thousand nine hundred and ninety-six.

PRESENT: HON. RICHARD J. CARDAMONE
HON. J. DANIEL MAHONEY
Circuit Judges
HON. MILTON POLLACK *
District Judge

Docket No: 95-7372

SPEAR, LEEDS & KELLOGG,
Plaintiff-Appellee,

v.

CENTRAL LIFE ASSURANCE COMPANY, ALEXANDER HAMILTON LIFE INSURANCE COMPANY OF AMERICA, INC., CANADA LIFE ASSURANCE CO.,
Defendant-Appellant.

Appeal from United States District Court
for the Southern District of New York

---

* Hon. Milton Pollack, United States District Judge for the Southern District of New York, sitting by designation.

This cause came on to be heard on the transcript of record from the Southern District of New York and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ORDERED, ADJUDGED, and DECREED that the judgment of said district court be and it hereby is reversed and remanded to the said district court for further proceedings in accordance with the opinion of this court.

FOR THE COURT

GEORGE LANGE III
Clerk

By: /s/ Beth J. Meador
BETH J. MEADOR
Administrative Attorney

Issued as Mandate 7/24/96.